Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Ashburn	Analyst:	Jahna Alvarado	Bill Number:	SB 445
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	February 26, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Manufacturers' Investment Credit/6 percent Of Qualified Cost Of Qualified Property Placed In Service In This State

SUMMARY

This bill would create a tax credit for purchases of certain property used in manufacturing.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to promote investment and job growth in the manufacturing sector utilizing a tax credit.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2009.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to resolve the implementation, technical, and policy concerns discussed in this analysis.

ANALYSIS

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

FEDERAL LAW

Existing federal law does not have a credit comparable to that proposed in this bill.

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STATE LAW

Previous state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) equal to 6 percent of the amount paid or incurred after January 1, 1994, and before January 1, 2004, for qualified property that was placed in service in California.

For purposes of the MIC, a qualified taxpayer was any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property was any of the following:

1) Tangible personal property defined in Section 1245(a) of the Internal Revenue Code (IRC), used in a qualified SIC Code activity, and used primarily for:

    - manufacturing, processing, refining, fabricating, or recycling of property;
    - research and development;
    - maintenance, repair, measurement, or testing of otherwise qualified property; or
    - pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that were an integral part of specified activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property included computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excluded certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process. Additional exclusions are facilities used for warehousing purposes and equipment used to store finished products, after completion of the manufacturing process, including tangible personal property used in administration, general management, or marketing.

The MIC statute was repealed by its own terms and ceased to be operative as of January 1, 2004, due to a reduction in manufacturing sector jobs.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within geographically targeted economic development areas (G-TEDAs). These incentives include a sales or use tax credit as discussed in greater detail below.

Sales or Use Tax Credit

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an economic development area (except a Manufacturing Enhancement Area). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone (EZ) or TTA:

- Machinery and machinery parts used for:
  - manufacturing, processing, assembling, or fabricating;
  - producing renewable energy resources; or
  - air or water pollution control mechanisms.
- Data processing and communication equipment.
- Certain motion picture manufacturing equipment.

LAMBRA:

- High-technology equipment (e.g., computers);
- Aircraft maintenance equipment;
- Aircraft components; or
- Certain depreciable property.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the EZ, LAMBRA, and TTA sales or use tax credit is $1 million for individuals and $20 million for corporations.

Assignment of Credits between Certain Unitary Affiliates

Under current state law, CTL allows the assignment of certain credits to taxpayers that are members of a combined reporting group and adds the following provisions:

- Provides that an “eligible credit” may be assigned by a taxpayer to an “eligible assignee.”
  - “Eligible credit” means any credit earned by a taxpayer in a taxable year beginning on or after July 1, 2008, or any credit earned in any taxable year beginning before July 1, 2008, which is eligible to be carried forward to the taxpayer’s first taxable year beginning on or after July 1, 2008.
  - “Eligible assignee” means any “affiliated corporation” that is a member of a combined reporting group at certain specified times.
  - “Affiliated corporation” means a corporation that is a member of a combined reporting group.
- Provides that the election to assign any credit is irrevocable once made and is required to be made on the taxpayer’s original return for the taxable year in which the assignment is made.

Current state law limits the amount of allowable tax credits for each taxable year beginning on or after January 1, 2008, and before January 1, 2010, to an "applicable amount." "Applicable amount" is equal to 50 percent of the tax before the application of any credits. Any disallowed credit remains a credit carryover to subsequent years and the credit carryover period is increased by the number of taxable years the credit amount was disallowed. Taxpayers with business income subject to tax of less than $500,000 are excluded from this law.

THIS BILL

This bill would allow a credit for taxable years beginning on or after January 1, 2009, of 6 percent of the qualified cost paid or incurred on or after January 1, 2009, of qualified property placed in service in this state during the year by a qualified taxpayer. The language in this bill for the proposed credit is substantially similar to the prior MIC law.

This bill would define "qualified taxpayer" as any taxpayer engaged in lines of business described in specified codes of the North American Industrial Classification Manual (NAICS)[1].

This bill would define a pass through entity as any partnership or S corporation and would specify that the determination of whether a pass through entity is a "qualified taxpayer" would be made at the entity level and any credit passed through to the partners or shareholders as specified.

This bill would define "qualified cost" as any cost that is all of the following:

- A cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition, or lease, of qualified property on or after January 1, 2009,
- An amount that the qualified taxpayer has paid sales or use tax on, and
- An amount that is properly chargeable to the capital account of the qualified taxpayer.

This bill would define "qualified property" as property that is any of the following:

- Tangible personal property as defined in IRC section 1245(a) that is used by a qualified taxpayer for any of the following:
    - o Primarily in the manufacturing, processing , refining, fabricating, or recycling of property;
    - o In research and development;
    - o To maintain, repair, measure , or test property, as specified;
    - o For pollution control that meets or exceeds standards as specified; or
    - o For recycling.
- Computers and computer peripheral equipment used by a manufacturer of computers or electronic products that is primarily used to develop or manufacture the following:
    - o Prepackaged software; or
    - o Custom software that the purchaser uses to produce, sell, or license copies of the software as prepackaged software.

[1] Published by the United States Office of Management and Budget, 2007 edition.

This bill would include special purpose buildings and foundations and capitalized labor costs for special purpose buildings and foundations as specified in the definition of "qualified property" for qualified taxpayers engaged in manufacturing activities related to the following:

- Biotechnology;
- Biopharmaceutical establishments;
- Space vehicles or parts;
- Space satellites, communications satellites, and equipment described in NAICS Code 51741; or
- Semiconductor equipment manufacturing.

This bill would specifically exclude the following from the definition of "qualified property":

- Furniture
- Facilities used for warehousing purposes after completion of the manufacturing process
- Inventory
- Equipment used in the extraction process
- Equipment used to store finished products that have completed the manufacturing process
- Any tangible personal property that is used in administration, general management, or marketing

This bill would allow the credit for "qualified property" acquired by or subject to lease by a "qualified taxpayer" as specified.

This bill would require a lessor of "qualified property" to provide a statement to the lessee that includes the lessor's original cost for the "qualified property" and the amount of the cost that sales or use tax had been paid on as specified. Additionally, this bill would require that the statement be made available to the Franchise Tax Board upon request.

This bill would disallow the credit for a lessor of "qualified property" if the "qualified property" is leased to another "qualified taxpayer."

This bill would define a number of terms, including "biopharmaceutical activities," "fabricating," "incidental use," "manufacturing," "primarily," "process," "processing," "refining," "research and development," "special purpose building and foundation," and "small business."

This bill would disallow this credit if in the same taxable year that the "qualified property" is first placed into service, the "qualified property" is:

- Removed from the state,
- Disposed of to an unrelated party, or
- Used for a purpose that does not qualify for the credit.

This bill would require that the credit be recaptured if, within one year from the date that the "qualified property" is first placed into service, the "qualified property" is:

- Removed from the state,
- Disposed of to an unrelated party, or
- Used for a purpose that does not qualify for the credit.

This credit would be eligible for assignment among members of a unitary group as specified.

Because this bill does not specify otherwise, this credit would not reduce regular tax below tentative minimum tax (TMT).[2]

Because this bill does not specify otherwise, this credit would be subject to limitation as specified

The bill would provide a carryover provision for any unused credit for nine years, or ten years in the case of a "small business", as defined, or until the credit is exhausted, whichever is shorter.

This bill would allow FTB to prescribe appropriate regulations to carry out the purpose of this bill, including any regulations necessary to prevent the avoidance of the application of the effect this bill would have through split-ups, shell corporations, partnerships, tiered ownership structures, or otherwise.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The taxpayer's eligibility for the credit would in part be based on the lines of business "described in" specified sections of the NAICS Manual.[3] However, the sections specified in this bill are the four digit SIC sections. Amendments are required to correct this inconsistency. Additionally, the term "described in" has resulted in disputes between the department and taxpayers under the prior MIC law. If it is the author's intent to allow this credit for taxpayers whose principal business activity is classified as manufacturing, the author may wish to substitute "properly classified under" for the term "described in" for clarity.

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[2] In the computation of the alternative minimum tax (AMT), various adjustments are made to regular taxable income to arrive at alternative minimum taxable income (AMTI). The minimum tax rate, which can be lower than the regular tax rate, is applied to AMTI to derive the tentative minimum tax (TMT). If the TMT exceeds the regular income tax for that year, the excess is the taxpayer's AMT for that year. On the other hand, if regular tax exceeds TMT, there is no AMT for that year.

[3] Published by the United States Office of Management and Budget, 2007 edition.

This bill uses the undefined terms “economical,” “packaging,” “placed into service,” “reconstruction,” and “recycling”. The absence of definitions for these terms could lead to disputes between taxpayers and the department, thus complicating the administration of this credit. The author may wish to amend this bill for clarity, and to the extent these terms have been defined, in the MIC regulation,[4] for example, the author may wish to use existing definitions.

This bill would allow specified manufacturers to include the cost of “special purpose buildings and foundations” that are “specifically designed and constructed or modified for a qualified purpose” in the calculation of the MIC. A building that would be “specifically designed and constructed or modified for a qualified purpose” is defined as a building that would not be “economical to design and construct … for the intended purpose and then use the structure for a different purpose.” The department lacks expertise in the economics of building design and conversion. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer.

TECHNICAL CONSIDERATIONS

The bill would include the term “value of capitalized labor costs” in the definition of “qualified property”. Because costs are not property, the term ”value of capitalized costs” should be removed from the definition of “qualified property” and added to the definition of “qualified costs”.

Subdivision (d) paragraph (2) of the personal income tax (PIT) and corporate tax law (CTL) provisions need to be amended where the term "Section 1245(a)” appears, as it should be "Section 1245(a)(3)(A)" to correspond to the definition of “tangible personal property” in the IRC.

The definition of “qualified property” includes five types of qualifying property. Because there are more than two types of qualifying property the term “either” that appears on page 10, line 40 should be replaced by “any”.

LEGISLATIVE HISTORY

AB 2076 (Dutton, 2003/2004) would have reinstated the previous MIC only for electric services. AB 2076 failed passage in the Assembly Revenue and Taxation Committee.

AB 1998 (Dutton, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005, and extended the MIC to activities related to electric service (power generation, transmission, or distribution). AB 1998 failed passage in the Assembly Revenue and Taxation Committee.

AB 2070 (Houston, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005. AB 2070 failed passage in the Assembly Revenue and Taxation Committee.

[4] Cal. Code Regs., tit. 18, §§ 17053.49-2, sub. (i), & 23649-2, sub. (i).

SB 1295 (Morrow, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2004, and increased the rate of credit from 6 percent to 8 percent. SB 1295 failed passage in the Senate Revenue and Taxation Committee.

SB 676 (Alquist, Ch. 751, Stats. 1994) made clarifying changes to the MIC and added provisions allowing the credit for leased property, but only to the lessee.

SB 671 (Alquist, Ch. 881, Stats. 1993) enacted the MIC.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. The survey was limited to income or franchise tax benefits related to manufacturing equipment.

Illinois provided a replacement tax investment credit equal to 0.5 percent of the basis of qualified property placed in service during the tax year (from July 1, 1984, to January 1, 2009) used by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining.

Massachusetts provides a 3 percent credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development.

New York provides an investment tax credit to manufacturers for certain depreciable equipment or buildings. The credit is 5 percent of up to $350 million of qualified expenditures and 4 percent for qualified expenditures in excess of $350 million. Certified pollution control, industrial waste treatment, and acid rain control facilities also qualify for this credit. Research and development property may qualify for an optional rate of 9 percent.

No comparable credit for *Florida* or *Minnesota* was found.

FISCAL IMPACT

This bill would require a calculation for the credit that would require a new form or worksheet to be developed. As a result, this bill would impact the department's printing, processing and storage costs for tax returns. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses.

Estimated Revenue Impact of SB 445 Effective for tax years BOA 1/1/2009 Enacted by 6/1/2009 ($ in Millions)				
	2009-10	2010-11	2011-12	2012-13
Manufacturing investment credit	-$285	-$425	-$455	-$495

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact was estimated as follows. First, the amount of MIC that would be generated in 2006 by corporations was estimated as the product of the 6 percent MIC rate and the qualified capital expenditure, which was assumed to be a fixed percentage of the total capital expenditure of California's manufacturing sector. The fixed percentage of 50 percent was derived from actual 2000-03 data as reported by corporations claiming the MIC for these years. The total capital expenditure for the state came from the Census Bureau's Survey of Manufactures. For the 2006 tax year, the amount of MIC generated under this bill would be approximately $422 million ($14.1 billion of total capital expenditures x 6% MIC rate x 50% ≈ $422 million).

Next, the estimated amount of the MIC generated in 2006 was extrapolated to later years. The extrapolation was based upon the latest Department of Finance forecast of California's capital expenditures for the manufacturing sector. Due to the forecasted decline in capital expenditures in 2008 and 2009, the amount of the MIC generated under this bill in 2009 is approximately $405 million.

Not all of the generated MIC would be used in the year generated as taxpayers without sufficient tax liability would be unable to fully use the generated credit. The unused MIC would be carried forward to subsequent years. The amount of generated MIC that would be used was simulated using a corporate microsimulation model that is based on a sample of corporate tax returns for the 2006 tax year. The model calculates tax liabilities based on the corporations' taxable income, net operating losses, stocks of available credits, and enacted tax laws that would affect credit use. Simulation results indicate that under the CTL for the 2009 tax year, approximately 49 percent of the generated MIC would be used by taxpayers to reduce taxes. The revenue loss to corporate taxpayers for the 2009 tax year is approximately $198 million ($405 million x 49% ≈ $198 million).

The revenue losses for later tax years were computed in a similar manner and include the additional impact of different tax laws and carryover MIC amounts.

Next, the revenue losses attributable to PIT taxpayers were added to the corporation results. The PIT revenue impact is assumed to be equal to the average percentage of the PIT MIC claimed to the corporate MIC claimed from 2000 to 2003. This average percentage is approximately 12.7 percent. The total revenue loss for the 2009 tax year for corporate and personal income taxpayers is approximately $224 million [$198 million + ($198 million x 12.7%) ≈ $224 million].

Finally, the total revenue impact on a taxable year basis was fiscalized to derive the results shown in the table above.

ARGUMENTS/POLICY CONCERNS

If this bill is intended to provide an incentive for future investments in the state's manufacturing sector, the inclusion of a prospective operative date may be appropriate to more fully act as an inducement for future action or behavior, rather than providing a benefit for action taken without regard to this credit.

This bill fails to limit the amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis.

Conflicting tax policies result when a credit is provided for an item that is already deductible as a business expense or is depreciable (double tax benefit). For example, under this bill a taxpayer could deduct the expenses for the costs of construction, reconstruction, or leasing and be allowed this credit. On the other hand, making an adjustment to reduce basis in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

This bill lacks a sunset date. Sunset dates generally are provided in tax incentive bills to allow periodic review by the Legislature. The author may wish to amend this bill to include a sunset date or benchmark, for example, the number of new full time manufacturing jobs created over a period of time in the state to allow periodic review of the effectiveness of the credit by the Legislature.

LEGISLATIVE STAFF CONTACT

Legislative Analyst	Revenue Director	Asst. Legislative Director
Jahna Alvarado	Jay Chamberlain	Patrice Gau-Johnson
(916) 845-5683	(916) 845-3375	(916) 845-5521
Jahna.Alvarado@ftb.ca.gov	Jay.Chamberlain@ftb.ca.gov	Patrice.Gau-Johnson@ftb.ca.gov